



# STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	<b>02/23/07</b>	Bill Number:	<a href="#"><b>AB 1600</b></a>
Tax:	<b>Sales and Use Special Property</b>	Author:	<b>La Malfa</b>
Related Bills:			

## BILL SUMMARY

This bill would:

- (1) Add a new provision to the Evidence Code to specify that the burden of proof is with the Board of Equalization (Board) in any assertion of penalties for intent to evade or fraud and require a clear and convincing evidence standard for such assertions, as specified; and
- (2) Add a new provision to the Government Code to shift the burden of proof from taxpayers to the agencies collecting taxes in any court or administrative tax proceeding or any evaluation of tax compliance as specified, under certain conditions.

## ANALYSIS

### **EVIDENCE CODE – STANDARD OF PROOF**

#### **Current Law**

Under existing law, Section 115 of the Evidence Code provides, in part, “Except as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence.” Section 160 of the Evidence Code defines “law” to include constitutional, statutory, and decisional law.

The Revenue and Taxation Code allows for civil penalties and even criminal sanctions for persons committing fraud or intent to evade the tax. California’s Evidence Code does not specifically provide for the standard of proof with regard to civil tax fraud. However, the standard of proof has been defined through decisional (case) law. Specifically, the California Court of Appeal in *Marchica v. State Board of Equalization* (1951) 107 Cal.App.2d 501 determined that the standard of proof in civil tax fraud cases was the **clear and convincing evidence standard**. A 2002 decision of the Ninth Circuit Court of Appeals, *California State Board of Equalization v. Renovizor’s, Inc.*, 282 F.3d 1233, relied on the *Marchica* decision in concluding that “clear and convincing evidence must be shown to establish civil tax fraud under California law.” Effective January 9, 2003, the Board amended its Regulation 1703(c)(3)(C) to state this agency’s existing standard of proof: “Fraud or intent to evade shall be established by clear and convincing evidence.” The 2002 *Renovizor’s* decision was the impetus for the Board’s amendment of Regulation 1703(c)(3)(C). However, the *Renovizor’s* opinion, as a federal court decision, is not controlling on matters of state law. (See, e.g., *Howard Contracting v. G.A. MacDonald Constr. Co* (1998) 71 Cal.App. 4<sup>th</sup> 38, 52.)

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### Proposed Law

This bill would add Section 524 to the Evidence Code to provide that in any proceeding to which the Board is a party, the Board shall have the burden of proof by clear and convincing evidence in sustaining its assertion of penalties for intent to evade or fraud against a taxpayer, with respect to any factual or legal issue relevant to ascertaining the liability of a taxpayer.

This provision would become effective January 1, 2008.

### In General

As a matter of law, fraud is never presumed, but must be proven and the burden of proof is on the Board. (*Marchica v. Board of Equalization, supra*, 107 Cal.App.2d 501.)

However, the standard of proof is not beyond a reasonable doubt as in a criminal prosecution. (See *Helvering v. Mitchell* (1938) 303 U.S. 391). Rather, the standard of proof is the "clear and convincing" standard as set forth in the Board's Regulation 1703(c)(3)(C). It is rare to find direct evidence that fraud has occurred, and thus it is often necessary and appropriate to make the determination based on circumstantial evidence. In addition, it would be difficult and unreasonable for the Board to assert fraud and then require the taxpayer to prove it never occurred.

### Background

During the 2005-06 Legislative Session, a similar bill was introduced (SB 633, Dutton). That measure was never heard in committee.

In the 1997-98 Legislative Session, (after the California Court of Appeal's 1951 decision in *Marchica*, but before the Ninth Circuit Court of Appeals' 2002 decision in *Renovizor's*), AB 1631 (Sweeney, et al.), was amended on April 15, 1998, to, among other things, clarify that the Franchise Tax Board (FTB) and Board have the burden of proof by "clear and convincing evidence" regarding penalties for intent to evade or fraud cases against the taxpayer. This measure died in the Assembly Appropriations Committee.

### COMMENTS

1. **Sponsor and purpose.** Board Member Bill Leonard is sponsoring this bill in order to codify the clear and convincing standard set forth in the Board's Regulation 1703.
2. **This Evidence Code change is consistent with the Board's current practice as well as case law, and makes sense.** It is appropriate that the standards for asserting penalties for fraud or intent to evade be the same at both the administrative and judicial levels. This bill would codify the decision made in the *Marchica* case so that the Evidence Code is clear that in the case of civil tax fraud, the standard of proof shall be the clear and convincing standard. It would also codify the Board's Regulation 1703(c)(3)(C) which states the Board's existing practice that in asserting fraud, the Board has to prove fraud or intent to evade by clear and convincing evidence.

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**GOVERNMENT CODE –BURDEN OF PROOF WITH COOPERATING TAXPAYERS****Current Law**

Under existing law, as a general rule, in civil cases involving the potential loss of money or property, the burden of proof is on the party in control of the facts. California law generally provides that taxpayers, like plaintiffs in other civil actions, have the burden of proving that the government's action was incorrect and establishing the merits of their claims by a preponderance of the evidence. The burden of proof is placed on the taxpayer since that is the party who has control of the records and documents.

*Under Federal law*, the Internal Revenue Service Restructuring and Reform Act of 1998, as added by Public Law 105-206, added Section 7491 to the Internal Revenue Code to place the burden of proof on the Internal Revenue Service (IRS) in any *court proceeding* involving a factual issue if the taxpayer introduced credible evidence with respect to the factual issue relevant to ascertaining the taxpayer's tax liability. Under this provision, the burden of proof shifts to the IRS if the taxpayer:

- (1) Complies with all the substantiation requirements of the Code,
- (2) Maintains all the records required by the Code,
- (3) Cooperates with the IRS' reasonable requests for witnesses, information, documents, meetings, and interviews, and
- (4) Meets the net worth requirements (the burden of proof shift does *not* apply to partnerships, corporations, or trusts whose net worth is more than \$7 million; no net worth limitation is applicable to individuals).

**Proposed Law**

This bill would add Section 15607 to the Government Code to provide that a state agency that collects and administers taxes shall have the burden of proof in any court or administrative tax proceeding, or any evaluation of tax compliance conducted by employers, contractors, or agents of the state agency, with respect to a factual issue related to ascertaining the tax liability of a cooperating taxpayer.

The bill would define the following:

- "Cooperating taxpayer," as a taxpayer who has both complied with all statutory, regulatory, or case law substantiation requirements to substantiate any item on any tax return filed with a state agency, and has maintained all records required by law or regulation, and has provided those records to the state agency, upon a reasonable request.
- "State agency," as the Board, FTB, and the Employment Development Department (EDD).
- "Tax liability," as any tax assessed by a state agency, including any interest charge or penalties levied in association with the tax.

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- “Administrative proceeding,” as with respect to disputes concerning taxes collected by the Board and the FTB, the hearing before the Members of the Board; and with respect to the taxes collected by the EDD, the hearing before the Unemployment Insurance Appeals Board.

The bill would also provide that, unless provided otherwise, the burden of proof upon state agencies for purposes of this part shall be a preponderance of the evidence, and that these provisions would not apply to an adjustment proposed and made to a taxpayer’s federal income tax return by the federal government.

The bill would provide that these provisions shall apply only to court and administrative proceedings involving determinations issued on or after January 1, 2008, the operative date of the bill.

### **In General**

Under the current Sales and Use Tax Law (Section 6091 of the Revenue and Taxation Code), it is presumed that all gross receipts are subject to the sales and use tax unless the taxpayer can prove otherwise. Under the Motor Vehicle Fuel Tax Law and the Diesel Fuel Tax Law, there is a presumption that fuel has been “removed” under certain circumstances, and when those circumstances occur, the fuel is subject to tax. (Revenue and Taxation Code Sections 7360, 7362-7364, 7373, 60050-60052, 60058, and 60064.) Other similar provisions that provide for the presumption of taxability are included in various tax and fee laws administered by the Board.

Under current Sales and Use Tax Law (and other various tax and fee laws administered by the Board), the Board may require a taxpayer or feepayer to furnish satisfactory supporting documentation for items reported on returns or claims for refund. At any point throughout the administrative process the Board may concur with the taxpayer. However, the Board may also determine that the documentation is not adequate to support taxpayer’s position. If the taxpayer does not provide a return, the Board may issue a deficiency determination to taxpayers who fail to file a return, based upon any information in the Board’s possession. If the Board believes that the collection of any tax or fee will be jeopardized by delay, it will issue a jeopardy determination, whereby the amount determined is immediately due and payable.

A taxpayer who disagrees with the Board’s determination of taxes may file a petition for redetermination. This petition prevents collection of the amount determined, except in the case of jeopardy determinations. All of the taxpayer’s contentions, including substantiating evidence in the form of books, records, or other documentation, are addressed with the auditor or appropriate Board staff. If Board staff confirms the legitimacy of the determination, a Notice of Redetermination is issued. The taxpayer may request an Appeals conference, at which the taxpayer may present facts and documentation in support of his position. After the taxpayer’s information is examined and authorities are researched, a Decision and Recommendation is issued by an Appeals attorney or auditor. If a taxpayer does not agree with the Decision and Recommendation, the taxpayer may request a hearing with the Members of the Board.

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The Board's role in appeals of FTB cases is different from that for sales and use taxes or other taxes and fees administered by Board. The taxpayer's forum for appealing an FTB action on a protest is a hearing with the Members of the Board.

A Board hearing is typically not scheduled until all other opportunities for resolution are exhausted, so that every attempt to resolve cases at the lowest possible level is afforded. In this regard, the five elected Board Members serve as the administrative appellate body in final actions of the FTB; and a Board hearing is generally the last step in the administrative appeals process of Board actions. In the independent review by the Board Members, there is a rebuttable presumption that the FTB or Board determination or redetermination was correct. Hence, taxpayers have the burden of proving that determination or redetermination was incorrect and establishing the merits of their claims which is by a preponderance of the evidence. This administrative review is performed without extensive evidentiary rules, designed to provide an environment that lessens the need for professional representation.

In the event of a final adverse Board decision, the taxpayer must pay the tax or fee in full before filing a suit for refund in Superior Court. In litigation, as with appeals, there is a rebuttable presumption that the government's action was correct.

### **Background**

During the 2005-06 Legislative Session, a similar bill was introduced (SB 633, Dutton). That measure was never heard in committee.

Several bills on this same issue, however, were considered in the past when the "Internal Revenue Service Restructuring and Reform Act" was pending before Congress. These include:

**AB 1488 (Pringle)**, as amended January 16, 1998, would have partially conformed state tax law to 1997 proposed amendments to federal taxpayers' rights provisions by modifying certain provisions of the Katz-Harris Taxpayer Bill of Rights, and by amending or adding to provisions governing the administration of the Personal Income Tax Law and the Bank and Corporation Tax Law, in regard to, among other things, the burden of proof in suits to recover amounts of tax and the standard of proof and the amount of damages recoverable in actions against the state with respect to FTB officers or employees. This bill died in the Assembly Appropriations Committee.

**AB 1631 (Sweeney, et al.)**, as amended April 15, 1998, would have, among other things, declared the intent of the Legislature to conform state law to federal law to shift the burden of proof in connection with taxes paid by taxpayers. This measure died in the Assembly Appropriations Committee.

**AB 1633 (Ortiz, et al.)**, as amended April 14, 1998, would have declared the intent of the Legislature to conform state law to federal law relative to the shifting of the burden of proof in connection with taxes paid by California income taxpayers. This measure died in the Assembly Appropriations Committee.

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**SB 1166 (Hurtt)**, as amended January 1, 1998, would have provided that the FTB shall have the burden of proof in any court proceeding with respect to any factual issue relevant to ascertaining income tax liability of a taxpayer, but only if certain requirements are met. This bill died in the Senate Revenue and Taxation Committee.

**SB 1425 (Hurtt and Kopp)**, as amended April 14, 1998, would have made findings and declarations that California should conform to the Internal Revenue Service Restructuring and Reform Act, which may include provisions that would shift the burden of proof in court proceedings from the taxpayer to the taxing agency. This measure failed passage in the Assembly Revenue and Taxation Committee.

**SB 1478 (Rainey, et al.)**, as amended March 19, 1998, would have provided that the Board, FTB, and EDD, and any state agency that collects taxes shall have the burden of proof in any court or administrative tax proceeding with respect to any factual issue relevant to ascertaining the tax liability of a taxpayer, but only if certain requirements are met. This measure died in the Senate Revenue and Taxation Committee.

## COMMENTS

1. **Sponsor and purpose.** Board Member Leonard is sponsoring this provision in order to incorporate into the California tax laws the same protections that federal law provides to taxpayers.
2. **The Government Code provision is broader than Federal law.** Federal law shifts the burden of proof to the IRS for all cooperating individuals, but restricts it to partnerships, corporations and trusts that have less than \$7 million in net worth. This bill would shift the burden of proof with respect to all cooperating taxpayers regardless of size. The argument in favor of limiting the federal provision to "small" businesses was that larger businesses are arguably capable of defending themselves in court proceeding disputes with the IRS without additional assistance. Opponents argue that the state equivalent to a tax court proceeding is actually the equivalent to a taxpayer's hearing in superior court. The administrative hearing before the Board Members bears little resemblance to a true judicial hearing.
3. **Who decides whether a taxpayer qualifies as a "cooperating taxpayer," and when do they decide it?** Would the Board have to decide this issue at the beginning of its administrative hearing, to determine whether the taxpayer or the staff had the burden of proof? Would a court have to decide this issue at the beginning of a trial, to determine the burden of proof?

Also, except for purely legal disputes, under what circumstances would a "cooperating taxpayer" have a contested tax liability? If a taxpayer has complied with all substantiation requirements and provided all records, it is not clear how there would be any remaining factual dispute. It appears that the decision on this issue would in effect determine the outcome of the hearing or trial.

In addition, currently, the rules for required records tend to be general--Regulation 1698, *Records*, requires taxpayers to maintain and make available for examination on request by the Board or its authorized representative, all records necessary to determine the correct tax liability under the Sales and Use Tax Law and all records

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necessary for the proper completion of the sales and use tax return. It would be difficult for the Board to prove that a taxpayer had not provided all records necessary to determine the correct tax liability under the Sales and Use Tax Law without being specific as to which records would be necessary. For example, if a California resident purchased a recreational vehicle for use outside of California, currently, the California resident would be required to submit receipts for gasoline, food, space rental, sundries, vehicle maintenance or repairs, or other items or services purchased out of state, a document showing registration out of state, evidence of an out-of-state residence address, or other documents to demonstrate the length of time that the vehicle was used outside of California before being brought into California. Would the Board need to require that a taxpayer provide certain documents to support an exemption before the taxpayer would be considered to be cooperating? Otherwise, in this example, if the taxpayer provided no records to demonstrate the location of the vehicle after its purchase, the Board would have no way to verify the exemption.

**4. Arguments in favor of shifting the burden of proof to the Board in any court or administrative tax proceeding with cooperating taxpayers:**

- **Proponents of previous similar measures believe that shifting the burden of proof may create a better balance between the taxing agencies and taxpayers.** Proponents believe that the placement of the general burden of proof on the taxpayers creates a perception of guilt until proven innocent and that a better balance would place the burden of proof on the government to show an increase in liability if the taxpayer complied with the procedural and recordkeeping requirements of the tax laws. That is, if the taxpayer is generally law-abiding, it should be the government's responsibility to show that the taxpayer's determination of liability was not correct.
- **Proponents state that the shift would not impose an unreasonable obstruction to the State in determining the correct tax liability.** Instead, good auditing practices should ordinarily produce sufficient evidence to sustain the burden of proof regardless of the shift.
- **Proponents argue that the burden of proof would continue to remain with the taxpayer for failure to maintain adequate records and comply with the law.** Many Board-audited taxpayers have lost their contested audits largely because they failed to keep "adequate records." The Board in many cases is required to determine these taxpayers' taxable sales through other techniques, such as mark-up audits. In such situations, under the proposed law, the burden of proof will still rest with the taxpayer.
- **Shifting the burden of proof onto the tax agencies is consistent with Federal Law.** Proponents state that this bill simply puts California in conformity with the IRS. The taxpayer's hearing before the Board Members is the state tax equivalent of a federal proceeding in tax court.

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**5. Arguments against shifting the burden of proof for cooperating taxpayers made on previous proposals:**

- **Opponents of previous similar measures argue that shifting the burden of proof to taxing agencies could benefit the most egregious tax offenders.** Because wage earners' and retired individuals' records are supplied to the IRS and FTB by employers and others, shifting the burden of proof to taxing agencies in these instances would be somewhat insignificant. However, businesses dealing primarily with cash transactions, those in the "underground economy," could benefit from a shift in the burden of proof.
- **Opponents contend that shifting the burden of proof away from the taxpayer could lead to more intrusive audits to substantiate the accuracy of an assessment.** When Congress was considering the IRS Restructuring and Reform Act, the Tax Executives Institute, representing approximately 5,000 corporate tax professionals, indicated in a letter to the Ways and Means Committee Chair that their organization fears that shifting the burden of proof will result in a much more intrusive IRS. "Tax Executives Institute is convinced that, if implemented, the proposal would lead to either a more intrusive Internal Revenue Service or a completely ineffective one. Neither one of those choices would be good for the country. ... If the burden of proof were shifted to the government in tax cases, the IRS's enforcement efforts would have to be intensified as the agency endeavored to sustain its heightened burden. If the taxpayer had no burden to come forward with the facts, the IRS would have to undertake to discover them itself. These intensified audits may well increase as the IRS struggles to reconcile reported income with expenditures. More summonses - including those issued to third parties - would undoubtedly be issued and more issues litigated. . ."
- **Opponents argue that shifting the burden of proof to the Board could result in additional record-keeping and administrative requirements.** The taxpayer is in control of the records and documents related to his or her tax return, and the current burden of proof requirement reflects this practice. If the burden of proof shifted to the Board, the taxpayer may have little or no incentive to maintain accurate documentation, and the Board would thus be burdened with attempting to reconstruct the documents. This would make the deficiency determination process extremely difficult and could result in more time-consuming audits involving third-party interviews, credit report requests, review of other agencies' returns, and/or searches for any available relevant documents maintained by the taxpayer and/or others.
- **Opponents argue that this bill may lead to a more formalized hearing process.** The current administrative review process is performed without extensive evidentiary rules, designed to provide an environment that lessens the need for professional representation. However, if the burden of proof is shifted, a more formal process may be necessary in order to produce substantial evidence and establish whether a taxpayer was cooperating.

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**COST ESTIMATE**

This bill could result in additional costs to the Board to support the state's position, to the extent that additional supporting evidence would be required on all cases. An estimate of these costs is pending.

**REVENUE ESTIMATE**

If this legislation leads to reduced reporting, departmental audit programs would be adversely impacted, resulting in lost revenues. However, the magnitude of the loss, if any, is difficult to determine.

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